By Ellen Wojahn

The take at the TOP

How growing companies manage the care and feeding of their key executives.

Their companies are small but healthy—averaging 37 employees, with pretax earnings of $308,500 on revenues of $4.5 million. Ninety-five percent of the organizations are privately held, and more often than not, the chief executive officer—who pulls down $71,797, including salary and bonuses—owns a controlling interest in the company.

The corporate decision-makers who responded to this year's INC. Executive Compensation Survey are heads-up, hands-on managers who know their companies inside-out. But compensation strategy is one issue that many of them would prefer to duck.

"If you're asking me what my system is—how I figure out how much to pay people—I haven't got one," a typical CEO admits. He reads, he knows what "tax gimmicks" are out there. He also keeps pretty close tabs on what the competition is paying. But he never seems to get around to designing a plan that is tailored to meet the goals he has for himself and his company. When business is good, there is no time. When it is bad, there is no money.

So, he sticks with the basics—salary, bonus, a sales incentive for the marketing guy, and the usual slate of benefits and perquisites. When annual reviews roll around, he goes on his guts.

"We're not doing much," he says, summing up. "But I'm sure we're not doing any less than what other companies are doing." A nervous pause. "Are we?"

A good executive-compensation package is a coordinated system of financial rewards that is designed to advance a corporate strategy. It is a collection of direct and indirect forms of remuneration, ranging from a simple paycheck to a variety of sophisticated capital-accumulation and equity-participation vehicles. Some are intended to reward, others to motivate.

The contents of the package—the things a company is "doing" for its executives--should depend on three things: what is happening in the job market, what the company's short- and long-term goals are, and which compensation vehicle will be most compatible with the corporate culture of the organization. Then there is the matter of tax-effectiveness—finding those modes of compensation that maximize both what the company is spending and what the executive is pocketing, while still keeping everyone out of trouble with the Internal Revenue Service.

Yet designing all of this requires a planning effort that many small companies are loath to put forth for a document that typically affects far fewer than a dozen people. Besides, it is such a ticklish matter, this business of trying to put price tags on people. Many corporate decision-makers would rather try to get by without any policies, at least for a while.

There really is no such thing as going "without policies," though. Even in the absence of a written plan, precedents are set, policies are developed, and the resulting de facto executive-compensation system works to shape the company's future. The question that executives should be asking themselves is: Are these the right policies for this stage of the company's growth? Is this the plan that will get the company where it wants to be?

The results of the INC. survey provide a snapshot of the packages that have been adopted by companies of various sizes, industries, and geographic locations. But the real story is behind the numbers—in where these companies have been, where they hope to go, and how their executive-compensation policies will, or will not, help them get there.

Research assistance for this article was provided by Joshua Hyatt.

Survey profiles: The Chief Executive Officer

Total compensation	$71,797
Base salary	$59,152
Percent receiving bonus	52%
Bonus, as percent of base salary	38%
Percent change in total compensation	25%
Age	45
Years in position	8
Years with company	11
Founder	67%
Board member	89%
Stockholder	92%
Average equity position	65%

The Company

Net sales	$4,553,418
Net income before taxes	$308,490
Total payroll	$841,148
Number of employees	37

THE "PAY-FOR-PERFORMANCE" TREND

Designing an executive-compensation plan, for many companies, has been viewed strictly as a matter of keeping up with the Joneses. If the competition raises salaries, then it is time to hike the payroll. If one company lengthens its list of perquisites or improves its health-care coverage, then the others feel obliged to do the same.

But it is seldom that simple anymore. Increasingly, companies are finding that they need to factor into their compensation decisions a variety of internal operating-strategy considerations that have little or nothing to do with what the competition is doing: such objective matters as cash flow, growth rates, and profit requirements. What the other guy is doing next door is still important—it just may not be as important as what is going on in one's own backyard.

The economy has had a lot to do with the change. After two crippling recessions, business is good—the current revenue and profit projections from the INC. survey are, in fact, stunningly optimistic. Some 90% of the respondents are anticipating sales increases averaging 43%, and 83% expect that boost to be reflected in a 69% jump in pretax profitability. But, consultants say, the lessons of austerity learned during the downturns haven't been forgotten.

"I think there have been some fundamental shifts in the way we conduct business in the United States," says Jerrold Bratkovich, a partner and general manager of the Los Angeles office of Hay Management Consultants. "We're going to see some significant changes in, and a longer term focusing on, a relationship between pay and performance that hasn't existed previously. My only fear is that the turnaround will be too good, too soon, and we'll fall back into the same traps."

For younger, faster-growing companies, this pay-for-performance thrust has meant shifting the emphasis from salaries and benefits to bonuses and incentives. The latter two are methods that don't increase fixed costs and, therefore, leave the company more flexible in times of economic downturn—which more than a few businesspeople are dourly predicting will return after the Presidential election, when Congress takes up the work of reducing the federal deficit.

For many older organizations, however, the switch isn't made so easily. Nearly 25% of the respondents to INC.'s survey are companies that were founded before 1958, and many have had to devise their own methods of meshing the new financial realities with their established ways of doing business. They may still be using salary increases as the chief means of improving the compensation package—as 72% of the survey respondents do—but more than a third report that they are moving away from discretionary raises and toward a more merit-based system. Take, for example, the case of a 60-year-old, $30-million telecommunications company on the East Coast that is still floundering for market share following the American Telephone & Telegraph breakup.

"We're expecting a down year," says the company's chief financial officer, "so we're playing our dollars in cash salary, because we don't expect there's going to be much to spread around. See, I've always paid a bonus at the end of the year, good years and bad—so I'll have to do that again. I probably won't increase employee benefits this year, because that's getting far too expensive a way of compensating people. So by elimination, it'll all go to salary, and in straight increments. I won't be lenient, though. Not everybody's going to get a raise."

Sweetening the pot: What companies did to improve compensation

Salary increases	72%
Additional benefits/ perquisites	39%
New annual-incentive plan	25%
New long-term incentive plan	14%
Special recognition/ awards	13%
Other	9%

Note. Total exceeds 100% because of multiple responses.

The focus, in other words, is on ways of assuring that the company gets what is sometimes referred to as a return on compensation. "Just coming to work and continuing to draw breath doesn't warrant a 10% annual increase anymore," says Peter T. Chingos, a partner at the accounting and management consulting firm of Peat, Marwick, Mitchell & Co. Across-the-board salary increases and discretionary bonuses are giving way, he says, to any of a number of bonus formulas and incentive structures, and salary increases are based less on established ranges than the achievement of certain individual or companywide performance goals.

Many of the executives polled for this year's INC. survey seem to have embraced the pay-for-performance concept. Incentives are gaining favor: 25% of the respondents say that one of the steps they took to improve their compensation package was to add an annual-incentive program, and 14% listed the introduction of a long-term incentive. Bonuses are paid to executives of 81% of the respondents, and, while about half of the companies still set both the size of the pool and the individual allocations on a discretionary basis, 49% of them say they now use a formula to establish the bonus pool. Well over half list sales goals, profit goals, and other benchmarks as the means by which individual bonuses are set.

Consultants who have reviewed these figures find them heartening, but surprising. "I just haven't known of many small companies that have instituted performance-oriented incentive programs," says Chingos. "I keep looking at the surveys to see if there's been a mistake in tabulating those figures, or whether [the respondents] could have misunderstood the question." He says neither is likely—which makes the numbers all the more intriguing.

William James, the partner in charge of compensation services for the consulting firm of Hewitt Associates in Lincolnshire, Ill., suspects there may be some exaggeration or wishful thinking at work here. "There's a lot of lip service paid to all of this—particularly in the area of salaries. Smaller companies that have been very informal in the past are coming to grips with the need to put more structure into the program. They want the tools that the bigger companies have had for a long time. But I'd have to say there are very few pay-for-performance programs that actually have teeth in them. You just don't hear about that many employees not getting their [salary] increases."

Edward Redling, president of Executive Compensation Service Inc., a subsidiary of The Wyatt Co., agrees. "They talk about pay-for-performance as if it were motherhood and apple pie, but when it comes down to it, a lot of managers aren't tough enough to step up to the hard decision—to tell that executive he's not getting what he thought he was getting."

There are exceptions, of course. Emmett Pace, owner and president of Oceana Corp., a 22-employee, $10-million-plus steel distributor in Darlington, S.C., is a good example. Not only has he turned down executives for annual bonuses "two or three times" when he felt they were "slackening off totally," he has also been known to deny himself a bonus. "I didn't think I did a good enough job last year," he says, matter-of-factly. "We were not as profitable as we should have been."

But Charles Vranich, vice-president and general manager of Childers Carports & Structures Inc., in Houston, says it is not only lack of gumption that prevents executives from installing pay-for-performance structures—it is a matter of survival. He and his partners, for example, had wanted from the beginning of the now 20-employee, $3-million manufacturing operation to establish a merit structure for their bonuses. Vranich was particularly keen on it, having worked for a large company that handed out lump-sum bonuses quarterly. "Everybody looked at it as just part of the salary," he says. "The first time the company had a bad

quarter and the bonuses didn't come, you'd have thought someone died around there." But, when it came to imposing a different set of rules in his own company, it just didn't seem financially feasible to do anything but leave them discretionary. Revenue was fluctuating too wildly. "If we'd have set bonuses as a percent of income, we'd have strapped the company."

While there are many companies that readily acknowledge the efficacy of imposing more structure on their compensation systems, there are also as many that steadfastly maintain that there is no need—in fact, no *place*—for salary ranges, bonus formulas, and incentive plans in small business. At least not in *their* small business.

"It becomes a game of numbers," says Philip W. Nace, founder and CEO of Nachem Inc., a Braintree, Mass., chemicals manufacturer. "If you devise an incentive plan that is strictly tied to performance against sales projections, the plan's going to be faulty to begin with. Remuneration is based on how much you go over budget, right? So, people lowball the estimates—there's no way to get around it." What's more, he says, the plans tend to discourage enterprise—whether the projections are met or not. "Once they've met them, they quit working. And if there's a downturn in the economy, and they know they're not going to get the incentive, you can bet they're not going to work."

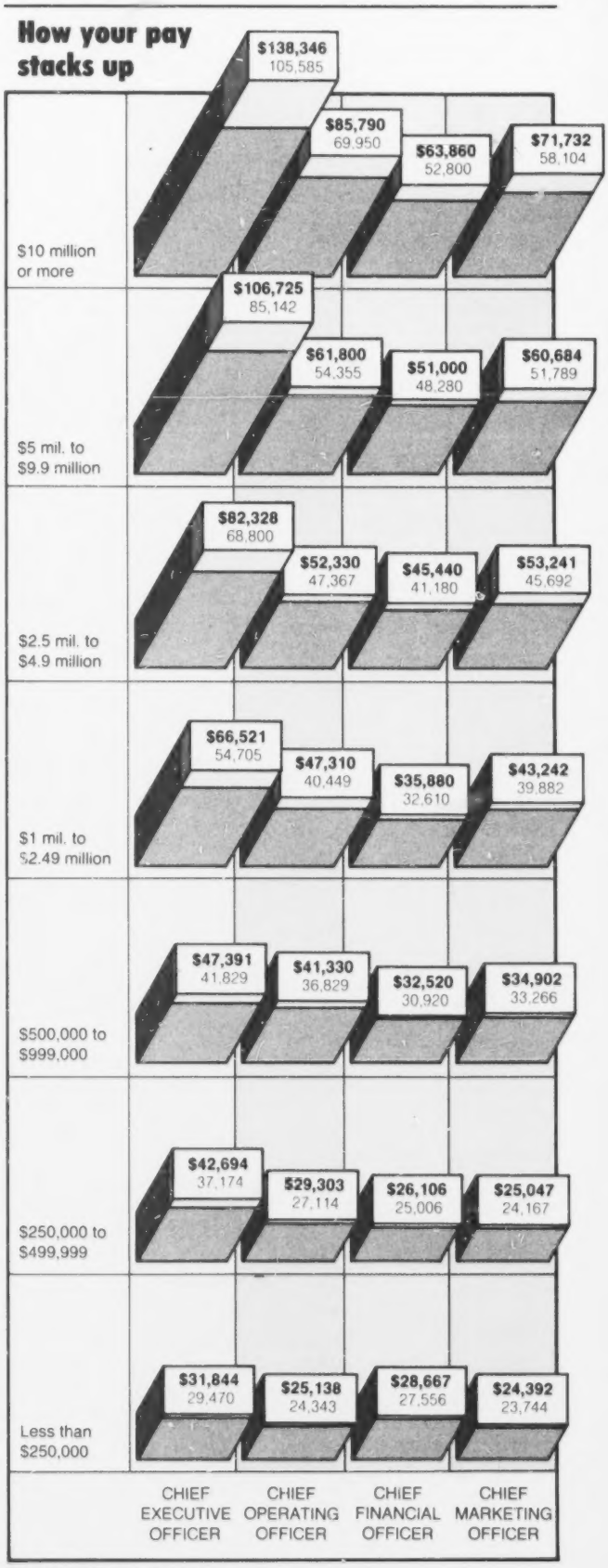
"Maybe we're just too lazy to start measuring performance," says Edmund Taylor, CEO of Gas Inc., a 58-employee, $10-million propane-marketing company in Union City, Ga. He used to pay "pure, reach-up-in-the-sky-and-grab-it-down bonuses that either you earn or you don't," but gave it up, recognizing that they weren't motivating his employees. Believing that "nothing motivates like getting paid on Friday and having job security," he put all of the would-be bonus money into salaries. It may not be the most scientifically designed compensation system, he says, but it is honest: "Now we pay what the job is really worth, rather than underpaying [the employees] a little bit and then giving them a big fat check at the end of the year."

Michael Keyes, too, rebels against management-by-mathematics. "With 26 employees, I just don't see that you have to be that structured," says the president and co-owner of Amsure Associates Inc., an $8.5-million insurance agency in Albany, N.Y. His bonus system, for example, has no ceiling, and no set pattern of size or frequency. "It's not that we're not goal-oriented; we just don't see the need to be so sophisticated, with bar graphs and bell curves. Any business under 50 employees is really run like a family. It *has* to be."

The owners and executives of small, closely held companies tend to have managerial environments that are indeed familylike, consultants say—usually with one person at the top who is either very paternalistic or egalitarian in managerial style. While the two styles are widely divergent in many smaller ways, they are the same in one broad respect: In both cases, there is a reluctance to distinguish among employees on the basis of performance. The CEO-owners see all underlings either as children or as equals. They tend to see corporate progress as a team effort, even when there are some individuals who deserve more recognition than others. And they don't believe they need graph paper to figure out what is going on within their four walls.

"In a small company, the owners are the managers—or they know the managers directly," says John McMillan, vice-president and director of compensation services with A. S. Hansen Inc., of Lake Bluff, Ill., "so they feel very competent in making equitable and fair reward decisions."

Often, company performance and individual performance are seen as one and the same. This is particularly common in service-oriented companies, in which the efforts of people are the products of the company, but it is also true in very small manufacturing operations. At Saugerties Packaging Corp., a 25-employee, $3.6-million manufacturer of paper wrappers in Saugerties, N.Y.,



Charts by Bruce Sanders

"everybody gets a bonus," says CEO Peter Garlock. "They run about 10% of salary, but they're based on profits, not performance. Everybody performs to their optimum every year, we feel."

And if they don't perform, they are likely to find themselves jobless. "If you can't give somebody a raise, then it's probably time to part ways," says Allen Guggenheim, president and chairman of Information Management International Inc., a 225-employee, $11.5-million maker of data-processing systems and software in San Jose, Calif. "It isn't easy, but when you're at that point, you should probably make it comfortable for them to leave."

But the fact of the matter is that in a small, closely held company with just a handful of executives, friendships and alliances develop that prevent the ouster of all but the worst managers. What's more, their compensation packages often continue to march upward in value at the same rate as that of their more productive co-workers. The long-term result, consultants say, is apt to be an overgrown management layer, where additional people have been hired above or below those who aren't measuring up. It is costly, and it can create problems.

Companies now find that they need to factor into their compensation decisions a variety of internal operating strategy considerations that have little or nothing to do with what the competition is paying.

"When I first came here three years ago, as a consultant, there was a sense of inequity among the executives," recalls Jim Hillgren, vice-president for human resources at Intecom Inc., a $120-million telecommunications-switch manufacturing company in Dallas that has grown at an 80% to 100% rate per year since that time. "Salaries, bonuses, and benefits were being determined arbitrarily, and some of the folks who hadn't grown as fast as the company found themselves in positions with less responsibility, but still getting the executive package. There was a sense of a lack of direction as to how people were being rewarded."

Since then, Intecom has gone on an ambitious structuring campaign—so ambitious, in fact, that Hillgren has found he has had to break rules almost as fast as he has made them. "We've probably tried to be too definitive," he says, "too attached to too-well-defined goals.

"There is a desire sometimes to make structure work for you, I think, instead of the skills of management. You rely too heavily on it, and the more structure you impose, the more you seem to have to tailor around it."

The trick to designing the best executive-compensation system for your company, says Peat Marwick's Chingos, is to strike a balance between too much discretion and too little. "You can't get by with one performance standard for the entire company, and you can't get carried away and devise so many structures that departments end up working against one another. There has to be a mixture."

He also advises meshing short-term thinking with longer-term strategic plans, with an eye toward linking compensation programs to a set of corporate goals, be they financial or cultural. But the most important thing, he says, is to "do what's right for you." Just because other companies are tilting toward certain kinds of capital-accumulation devices or incentive techniques doesn't mean either option is right for your company. "There's a tendency to look for cookbook solutions," Chingos says, summing up, "and it's just not that simple. There really are no cookbook solutions."

OFFERS THEY CAN'T REFUSE

"It's always 32 for 32," groans David Corbett, vice-president/partner of Korn Ferry International, an executive-search firm based in Los Angeles. "Small companies are always asking me to find them a young tiger of 32 who'll come to work for $32,000." Either they haven't priced MBAs lately, he says, or they have an inflated notion of their company's attractiveness to job-seekers. He suspects the latter.

"They're entrepreneurs in heat. They're building a company, and having a lot of fun doing it, so they think all the hotshots naturally want to work for them." Corbett laughs ruefully. "They don't realize there are 10 other companies that want that same guy." And many of them, particularly the larger ones, he says, may be offering far better deals.

The success or failure of a small, growing company depends in no small measure on its ability to attract *and* retain good executive talent. Even companies that are committed to promoting from within sometimes find themselves chasing executives from other, often larger, corporations with better-structured compensation plans. Yet, many of these smaller companies seem to operate on the assumption that they can recruit the talent without offering a generous, tax-effective—in other words, *competitive*—combination of direct and indirect compensation.

"I believe in doing only what I feel I can comfortably do for my employees," says the CEO of a southern steel distributing company. "I can't worry about what other companies are doing. Of course, if they took all my people, then I'd have to start worrying." But that isn't likely to happen, he says, because "this is a great place to work."

"You don't need to put together as fancy a package when you're offering people the opportunity to work in an entrepreneurial environment," agrees an East Coast furnishings supplier. "Give them what they can't get at a larger company—responsibility and a chance to affect some of the decisions, mainly—and they're happy."

There's certainly truth in that, says John Cooke, founder of The London Group Inc., a Spring Lake, N.J., management consulting firm. "You see almost a Svengali-like influence on those who work for an entrepreneur," he explains. There are indeed second-tier executives who gladly accept the unstructured, reactive policies of the smaller company—policies that are generally set and shaped not by the employment market, but by what is best for the entrepreneur—just to be free of the larger corporate structure they knew before. But, as many companies are learning, there are also quite a few other good prospects who, while tantalized by the opportunity to work for a young, growing company, just can't bring themselves to make the sacrifice.

"They participate in a variety of short- and long-term incentive plans, not to mention capital accumulation, supplemental retirement, deferred compensation, and everything else," says Peat Marwick's Peter Chingos. "So, if you want an executive from a larger company, you've got to first make that person whole [match the prospect's current compensation package], and then make it interesting on top of that." And that is no mean task for a lot of small companies, Chingos says, because designing an attractive compensation package often requires the use of techniques and vehicles that small organizations can't—or won't—put on the table.

Because they are often cash-poor, small companies on a recruiting job simply may not have the option of paying huge salaries. Nor can companies simply dangle a long list of perks. They have come to be gun-shy in that area, since Congress and the IRS have been cracking down on cars, clubs, and the other goodies that once were the favored tools of small companies seeking to maximize their executives' income.

And many CEOs dislike offering a beefed-up benefits plan for executives, because benefits represent costs that are at once too fixed and too difficult to control. Flexible-benefits plans can be

more effective, maximizing the benefit to the executive while at the same time capping the total expenditure. But only 10% of the companies that reponded to the INC. survey are taking advantage of these plans. Consultants attribute the disinterest to widespread confusion over how such plans work, and, as of this spring, stricter IRS policies regarding them.

Deferred-compensation options are painless enough; in fact, they give a corporation added working capital during the deferral period. But they tend to be unpopular with would-be new hires. How can the executives be sure their company will be around in three years, or five years, whenever they might want to take the cash? If the company should go under, they would be waiting in line for their pay, along with every other unsecured creditor.

Small companies often forget, says Hay Management's Jerrold Bratkovich, that leaving a large organization for a small one can look like a risky proposition. "To attract and hold good people, you've got to offer an upside that compensates for the downside," he says. "You've got to balance risk with reward." It takes a willingness to tailor individual compensation packages—not to mention some creative negotiating skills.

Michael Whalen can vouch for that. As owner and founder of The Cheese & Specialty Foods Co., a 35-employee, $11-million operation in Denver, he recently went through an "exhaustive" search for a vice-president of marketing and sales. He eventually nabbed one, a 15-year veteran of competitor Nobel/Sysco Food Services Co., but it took a highly lucrative compensation package to pry the man loose. The terms are these: a salary of $65,000 a year (more than Whalen himself is taking in direct compensation) plus a deferrable bonus that is tied to certain annually set goals in the areas of gross margins and return on assets. And the clincher is this: The new vice-president will get equity, after certain retained earnings goals have been met.

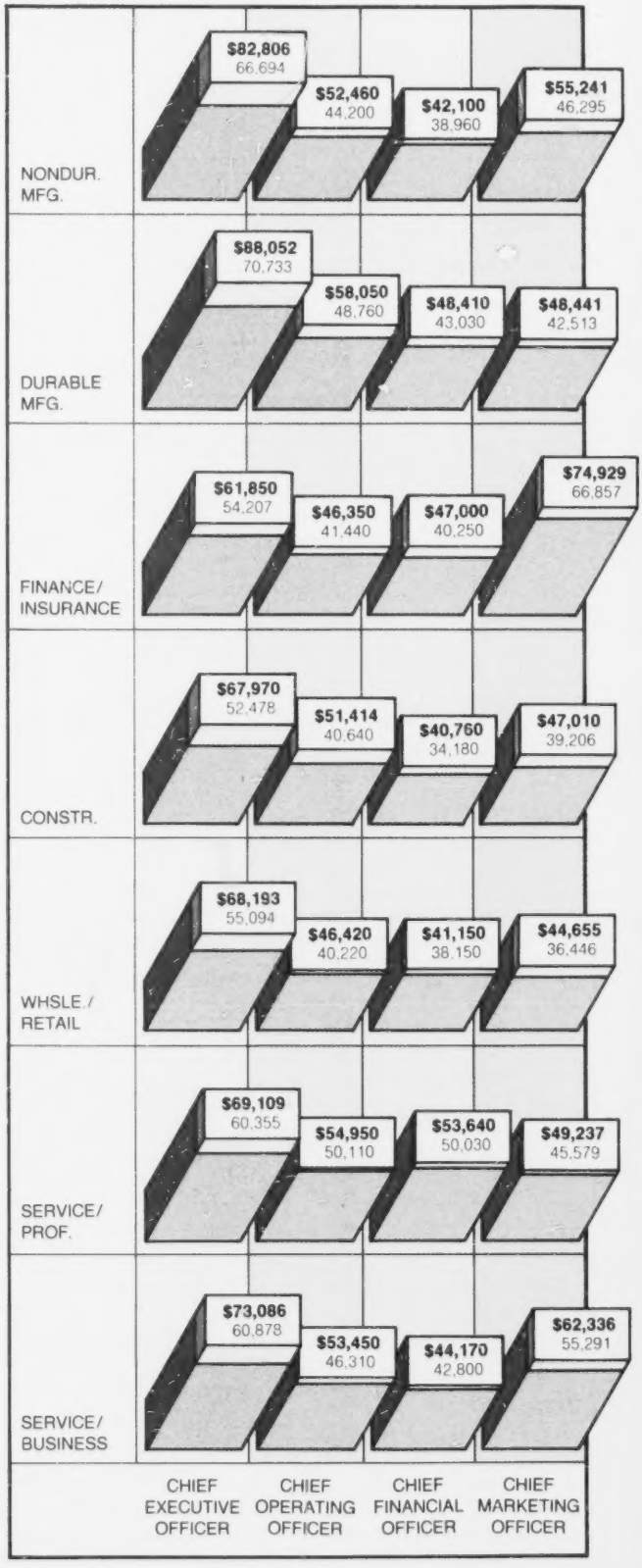
"I want to surround myself with better people," says Whalen, explaining his generosity. "I don't care if the vice-president is making more money than I am, if he can do what he says he's able to do." But salary and bonus alone probably wouldn't have been enough to grab this candidate or any of the large-company candidates Whalen interviewed. He found that they want the one thing small-company executives are least willing to part with: equity. "They want to be the conductor, and if they don't see the baton, they don't want to negotiate."

"When companies find a good candidate nowadays, you've got to start from scratch," explains Corbett, the recruiter. "You've got to talk about what the candidate wants, what the spouse wants, even what the kids want." As a result, he says, you do hear about equity and equitylike vehicles that give the candidate a feeling of participation. You hear of $2-million and $3-million companies offering salaries of $30,000 to executives—sweetened with $100,000 bonus opportunities. You also hear about one-time, front-end bonuses, signing inducements such as mortgage differentials, generous allowances for a spouse's job search, or agreements to provide education for a special-needs child. "All the old rules have gone out the window," he says.

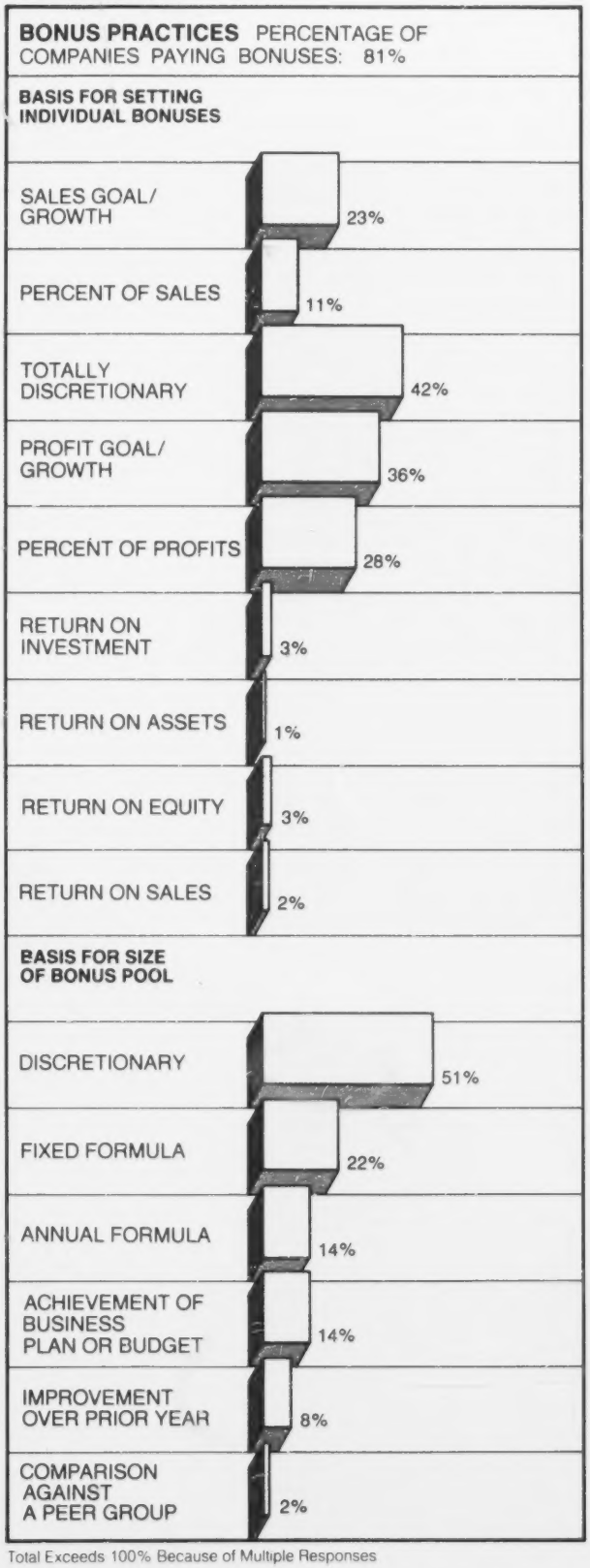
But what happens once that prized executive comes aboard or is brought up through the ranks to a senior position? Again, there is a tendency for chief executives to overemphasize the sheer challenge of growing a company as compensation in and of itself. CEO-owners have been known to sit on salary increases and balk at installing the devices that allow executives to pocket more income with lower taxes—and sometimes for quirky reasons.

"Our previous leadership didn't believe in this so-called tax gimmickry," says Terry Blakely, controller of Universal Steel Co. of Michigan, a 70-employee, $15-million distributor in Lansing. "They were unusual, in that they felt a certain pride in seeing themselves and their employees paying all the tax they could pay. They didn't care much for the little angles against the income tax system, so they never took into account how to get more money

How your pay stacks up—by industry



Slicing up the profit pie



Total Exceeds 100% Because of Multiple Responses

to the employees. Now, long-term disability, supplemental life, deferred bonuses—these are ridiculous things to lose a person for, especially when you know it's going to take several years to really replace somebody. But they didn't seem to see that. They paid you your salary, and that was it."

Sometimes, consultants say, that salary seems inexplicably frozen. And when that is the case, there is usually a CEO-owner in the background, who—unlike Cheese & Specialty Foods's Whalen—is feeling a bit crowded by the compensation he or she is shelling out to the rest of the top team.

"Many of these guys are grossly underpaying themselves," says Wyatt consultant Ed Redling, "so they hold everybody else's compensation down." They forget, he says, that they hold equity. All they remember is the figure on the stub of the paycheck, and if somebody else's numbers are getting too close, it is admittedly hard to take. "I can't see somebody else earning more than I do," says Edwin J. Snyder, of E. J. Snyder Inc., a $2-million Baltimore mechanical-construction contractor. "If they did, I'd do what they do."

The CEO can sometimes be convinced to pay his subordinates better, but Redling usually approaches the problem from the opposite direction. "I've had to convince several [CEOs of small, privately held companies] to take significantly more—whether it's salary and bonus or whatever. Just move his total comp up so he could pay his second line much more effectively, much more appropriately."

If there is one executive that the CEO-owner of a growing company almost always takes good care of, however, it is the chief marketing officer. "The typical entrepreneur in a young, small company will compensate people in relationship to his product market," explains consultant Cooke. "And in the growth stage, sales are everything. Salesmen, in fact, are often paid disproportionately just because the entrepreneur needs them so much." The INC. survey shows that while chief marketing officers are less likely than the other members of the executive team to receive stock and/or board positions, they are often paid more direct compensation than some of their colleagues. For example, the average CMO gets a higher salary, and—in bonus-paying companies—receives a bigger annual increase as a percentage of base pay than the average chief financial officer.

"Marketing is everything right now," says Michael Drake, CEO and part-owner of Brell Mar Products Inc., of Jackson, Miss., explaining why he recently gave his chief marketing officer stock in the $1-million company, which makes hunting and marine accessories. "I can't afford to lose my guy, so I've got to find out what turns him on, and give him that. Within reason, of course."

Traditionally, the same has not been true for executives in engineering or research-and-development posts. Technical people, in fact, are frequently the last considered for improved compensation packages. That situation, says Bratkovich, is unfortunate and downright wrongheaded. "Talking about executive compensation without including your key technical talent—you just can't do it. It is, after all, in its purest sense an asset-management, risk-management kind of thing. You have certain human-resources assets, and to the degree that those assets are critical to long-term survival, you build insurance programs, if you will, to protect those assets."

Corbett says a key part of that asset protection involves recognizing that the entrepreneurial bent that first attracts candidates to a start-up can also encourage them to strike out on their own someday. Many an entrepreneur has scoffed at the idea of designing compensation vehicles to deter such defections.

"I have a feeling," he asserts, "that compensation packages that orient themselves around that issue—that give the executive more recognition, more opportunity for freedom—are the packages that are going to be most successful in attracting and retaining executives."

CREATIVE COMPENSATION

They like to think of their companies as creative, innovative organizations, blazing paths that larger companies can't or won't travel. But, when executives of small, closely held companies start to critique their own compensation policies, high on their list of defects is just that: a lack of creativity. And many are of the opinion that they could spark more innovation by paying better attention to how larger companies are confronting compensation issues.

"Tapping into what the big guys are doing—that's how you find out what vehicles are out there, and how you can plug them into your operation," says the CEO and co-owner of an Ohio construction-contracting company. "There's where the ideas come from." He is fascinated by the latest capital-accumulation plans, and, until the IRS declared "invalid" some versions of them, flexible-benefits options had looked good to him, too. So, as this CEO looks to enlarging his board of directors, one of his priorities will be to find at least one person who can keep him informed of such innovations, and offer advice as to their application in his organization.

Some consultants say that smaller companies have an inferiority complex: They assume that larger organizations are the only ones that are capable of innovative executive compensation packages.

Consultants, however, suspect that there is an inferiority complex at work here—one that causes small-company executives to overlook the freedom they have to devise new compensation vehicles and policies specifically attuned to their own needs. "Smaller companies shouldn't be waiting for the larger companies," says consultant Edward Redling, of Wyatt's Executive Compensation Service. "They have a great opportunity to innovate on their own, because in a small company, everybody knows everybody. They can get things done outside of the bureaucratic process, which tends to institutionalize compensation policymaking in larger companies."

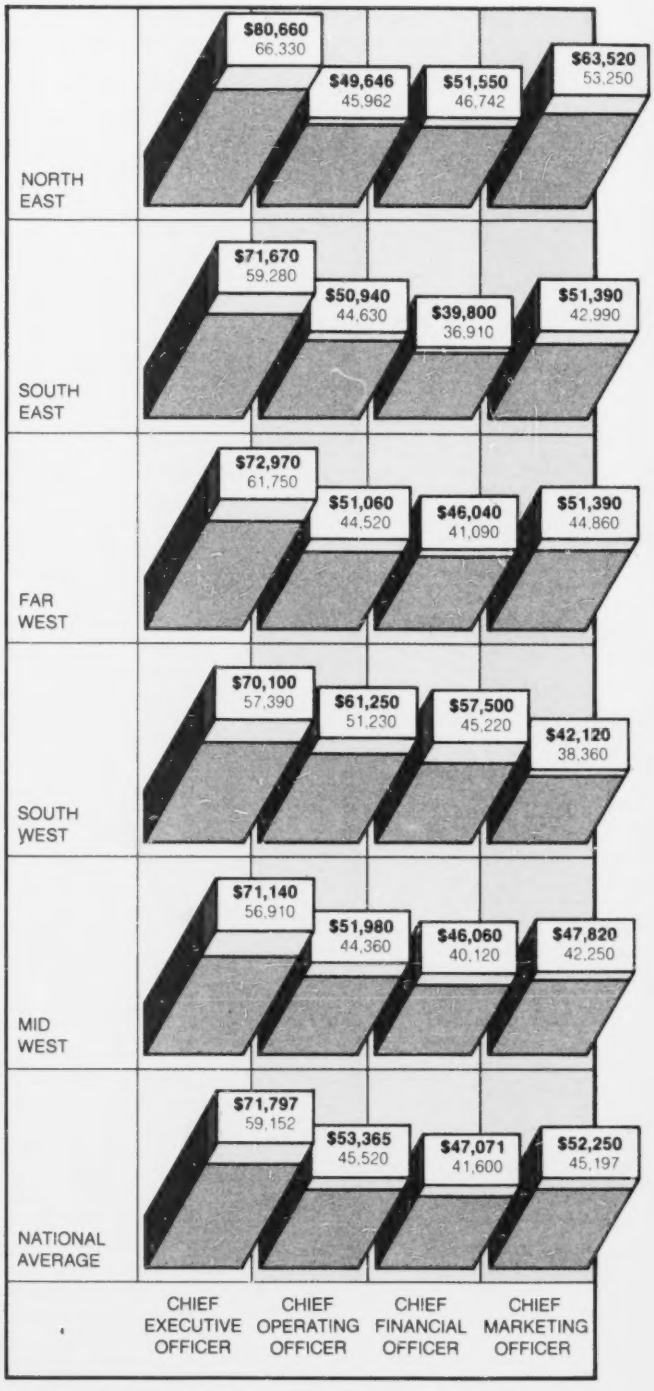
Large companies haven't exactly proven to be role models when it comes to dealing with change. They haven't been any more adept than their smaller counterparts at dealing with some of the more pressing compensation issues of the decade: such issues as how to create challenging promotions for people who don't care to ascend just to the next managerial level, or how to individualize packages for executives whose job descriptions and production habits defy nine-to-five, annual-review parameters. What's more, Redling says, the most effective compensation packages are those not merely discovered and "plugged in." Rather, they are developed or tailored to shape and reflect the individuality of the organization.

Hay Management's Jerrold Bratkovich agrees. In a more perfect world, he says, executive-compensation decisions would not be made strictly with finances, in-house politics, and the competition in mind. "I think the most important question that small-company executives can ask themselves is, Does our reward system support the kind of behavior we want from this organization—the kind of culture we want to develop here? And, if not, how do we restructure it? It shouldn't be, What are the large companies doing? It should be, What can we do differently for ourselves? What can we do that's best for our stage of development and our kind of people?"

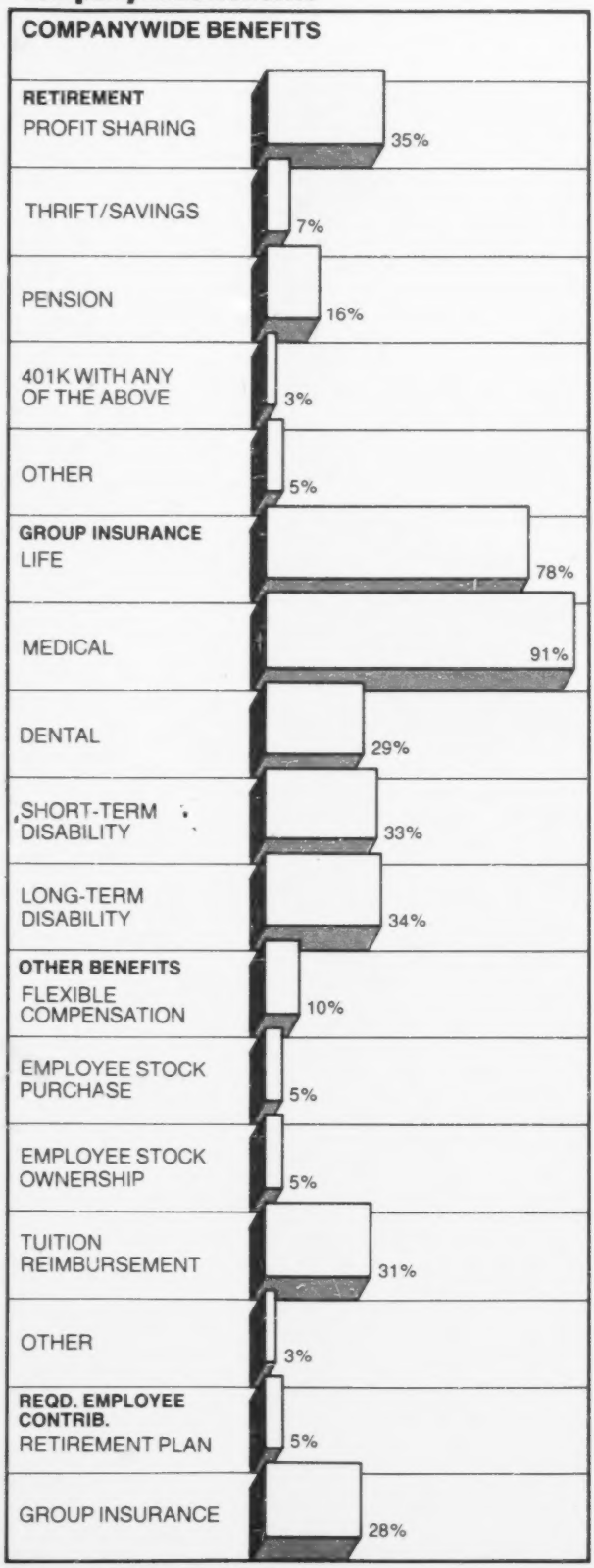
Some companies, for example, are seeking to devise criteria for recognition programs that are more like achievement awards than hard-number performance incentives. Others have noted that they can get four times the psychological benefit from their bonus plans simply by paying them out in quarterly distributions. But not all of the self-examination that Bratkovich favors has to do merely with which compensation vehicle, or which compensation policy, works best. Gradually, companies are coming to realize that they can—and often inadvertently do—make corporate-culture statements in their design of a compensation package. Here and there, executives are recognizing what those statements are—and either they are capitalizing on them, or are designing them out.

(continued)

How your pay stacks up—by region



On the fringes: companywide benefits



Total Exceeds 100% Because of Multiple Responses

One of the more interesting trends Bratkovich has noticed is a tendency among high-growth, high-tech companies—particularly on the West Coast—to veer away from status perks. "Clubs, cars, first-class air travel—many of them won't touch any of those perquisites with a 10-foot pole," he says. "They distinguish between people too much. They want their people to work together, survive together, and grow together."

Data I/O Corp., a computer-component programmer manufacturer in Redmond, Wash., is one example. The 500-employee, $36-million company has adopted a series of executive-compensation policies designed to draw as few lines as possible between employees of various levels. There are company cars for some managers, but no assigned parking spots. There are bonuses, but they aren't discretionary; they are based on a formula related to pay grade. There are stock options, but the criteria for allocation is open for all to see and strive toward.

"We have lots of engineers here," explains Pamela Alexandra, Data I/O's manager of compensation and benefits, "and their education makes them very rational and very egalitarian. They like to be in the kind of atmosphere where everybody is treated fairly, and having a lot of perks doesn't give that impression." By making what perks there are open and apparently attainable, Alexandra maintains, Data I/O has prevented walls from developing between different layers of personnel and threatening the team atmosphere the company has tried to foster. In fact, the company has chosen to literally tear down what few walls there are within the plant. "We don't want to have a business where people hide in their glass offices and never mingle," asserts Alexandra.

On the other hand, there is the example of a 1,000-employee, $50-million conference-center operator that has instituted policies that have had the effect of separating the top brass even more from the rest of the managerial work force.

With the goal of better compensation for his most valued executives, the CEO-owner devised a special cash incentive, payable to only 6 of his 25 top managers. He did it through the establishment of an S corporation (formerly called a Subchapter-S corporation)—a management-company subsidiary that, on paper at least, sells services to the parent organization. Its "profits" provide cash payments that, unlike equity—the value of which can fluctuate with sales and earnings—remain dependably lucrative over time. Some executives, in fact, are doubling their salaries through the plan.

The company's CEO-owner believes that there is sound reasoning behind his decision to reward so richly so few. "My feeling is that the top 6 employees have an enormous impact on the other 994, so that's where I put my emphasis. Funds are not unlimited, you know." He also defends his not-inconsiderable efforts to keep the existence of the plan under wraps. "Everybody wants to be a vice-president anyway," he explains. "Describing the economic elements of that position would only accelerate the interest. There's no benefit for me to try to motivate in that way, and, frankly, I'm convinced that compensation knowledge can be a demotivator."

This CEO-owner bases his conclusion on a conversation he had with his chief financial officer shortly after the S corporation was formed. The CFO, a most-trusted employee, was insistent that he know how his cut of the spoils compared with those of his colleagues.

"I always thought the comparisons went on only at the lower echelons," the CEO-owner says. He found it "a real eye-opener" that a man so high on the corporate heap would be brooding over such an issue. So, perhaps he can't be accused of creating a work atmosphere that is predicated on openness and egalitarianism, but, "it *is* dedicated to harmony," declares the CEO-owner. "From what I've seen, public knowledge of compensation information simply doesn't create harmony."

EQUITY, THE SECRET WEAPON

Gus Constantino would sooner sell out than offer his executives stock in his company. He relishes the flexibility, the discretion—the control—that comes with being CEO and sole owner of $3.5-million Wilson Feed Co., in Richmond, Va. "I'm a hard person when it comes to sharing all of this," he says. Stockholders are stockholders, he reasons—whether they hold 8% or 80%—"and when you give them any piece of the company at all, they automatically think they deserve some authority." To his way of thinking, Constantino says, running his feed, seed, fertilizer, and chemical distribution business is a solo act, and he is not about to do anything that would let his employees upstage him. "Either I'm the show, or I'm not the show," he shrugs.

But the pressure is on to share the spotlight. Ownership, and the right to participate in the growth of a company, has rather suddenly become something that many senior executives desire—if not demand. They have seen the risks and rewards of entrepreneurship, and they want to experience them for themselves. They have watched as companies have gone public in record numbers—there were close to 1,000 initial public offerings in 1983 alone—and they have seen their bosses, the founders, get rich. If they have devoted the time, the energy, and the talent to make a risky venture a success, they figure they have earned the right to share in the pride—and the payoff.

Consultants agree, giving glowing accounts of how much more motivated, how much more "team-oriented" executives become when they have a personal, financial stake in the company's future. Whether the game is attracting, developing, or motivating executives—or trying to foster a certain corporate culture—equity is the trump card that small, growing organizations hold against larger competitors. And deciding whether or not to play that card is becoming an increasingly inescapable part of designing a compensation package.

At first glance, equity wouldn't seem to be much of an issue for the overwhelmingly private, closely held companies that dominate this year's INC. survey. The average company's stock is 86% internally held, and while the vast majority of it is held by the CEO-owner, a quick perusal of the executives in other positions shows that about half of them own stock, and that the average equity position runs as high as 26%. Many of these shareholders, however, are co-founders. Rare is the company that is using equity as a long-term incentive for other executives. A mere 9% report having a stock-option plan, and other equity or equitylike vehicles—such as nonqualified stock, stock grants, and phantom-stock plans—come in at 2% or less. Eighty-five percent of the respondents report having no long-term incentives at all.

Many owners have a difficult time seeing equity as a compensation tool; to them, it is a highly charged, emotional issue. Their business is just that—*their* business—and they are extremely reluctant to give up any part of it. The personal and economic sacrifices they, and their families, made to get the company off the ground are just too fresh in their minds.

"When you give up equity, you're giving up quite a bit of profit and capital appreciation," explains Gerald Frank, chief executive officer of Greenacres Gypsum & Lime Inc., in Spokane, Wash. He and his five co-owners have discussed giving stock to some of the company's up-and-coming managers, and so far, they have chosen not to. After several years of struggle, "we have a very profitable company," Frank says of the $2-million nonmetallic-mineral-processing operation, "and all of the stockholders feel as I do—it's just too *good* right now."

Long-term incentives: The stock answer—no

None	85%
Incentive stock option	9%
Nonqualified stock	2%
Stock grant	2%
Phantom stock	1%
Other	2%

Note: Total exceeds 100% because of multiple responses.

"It's basic greed," says Robert Kramer, vice-president and partner of Brookdale Plastics Inc., a $1-million manufacturer of thermal-formed plastic in Minneapolis. "People who are reluctant to give away equity are people who don't feel they have enough money."

Not that Kramer doesn't understand the syndrome. Only a year ago, he and his partner were "brown-bagging it, sharing leg space under a desk," and drawing no salary whatsoever. "When you're in that survival stage, the last thing you want to talk about is giving away profits—especially when there are barely enough to feed the company. But I think that when you get to the growth stage, if you sit down and analyze it, you can see the benefits." He and his partner, in fact, have considered giving equity to a new member of the executive team. Why? "You just have to presume a guy will take better care of his own company than he would someone else's."

Paradoxically, that is exactly what many CEO-owners fear most: The new stockholders might ask too many questions, offer too many opinions—expect too much power.

"It's kind of a phobia with many entrepreneurs—a crack-in-the-dam sort of thing," says Jerrold Bratkovich of Hay Management. "Giving up 10% of the company isn't going to make one iota's difference in their ability to make decisions or run their companies. But they figure if they give up even that much stock, pretty soon they'll only have 49%. So they are very unwilling to give up any at all."

Some owners, having become convinced of the merits of sharing equity, but not of their ability to retain control, have nevertheless found ways to work around their anxieties.

Kitchen Concepts Inc., a $3-million, Taunton, Mass., company that designs, installs, and distributes kitchen cabinetry, is rewriting its bylaws to prevent a new stockholder from exerting too much influence. "We were a 50-50 partnership, and we were each willing to give her 5%, but we didn't want to give her the ability to throw the vote," says CEO Cameron Snyder, so he and his partner set up a board of directors, and required a two-thirds vote on all decisions made.

There are others, however, who say that equity is worthless if it doesn't carry the opportunity to affect company policy. What is the point of owning stock, they ask, when the CEO can still countermand anything the minority shareholders propose?

The point, says Peat Marwick's Peter Chingos, is reward—and motivation. "The executives on the second tier are typically making about $50,000, and giving their all for the company. They want equity as compensation for past service and for that feeling of being part of the team. It's not for voting control."

That is why phantom-stock plans—in which no real stock is issued, but shareholders profit from the increased value of the company over time—are often as welcome to many executives as the real thing. Only nine respondents to the INC. survey listed using such plans, however. Blame it on lack of awareness, the compensation experts say, and on the preoccupation of many CEOs with confidentiality.

"Sometimes the owners are very reluctant to share enough information with the people who might logically participate in a phantom plan," says Wyatt's Edward Redling. "They don't want anyone to know what the numbers are." If they did, he says, they would have gone public a long time ago.

But staying private doesn't mean that they can—or should—avoid the question of equity anymore.

"This emotional, it's-mine-and-I-own-all-of-it point of view," says Bratkovich, "can be a real block in recruiting the kind of people they'll want to attract in the future—most of whom are now very much equity-minded."

THE TAKE AT THE TOP continues on page 55.

PUTTING YOURSELF ON THE PAYROLL

When Steven Pruchansky went into the waterbed business in 1978, nobody told him how much he ought to pay himself. He picked a figure out of thin air—$20,000 a year—and held himself to incremental raises for the first few years of operation. Only recently, after Advantage Distributing Inc.'s sales began to approach $15 million, did he start to take any substantial amount of direct compensation out of the Haverhill, Mass., company. "The company couldn't afford it until then," he shrugs. "And that's the basic compensation criterion, as far as I'm concerned—what the company can afford."

When you own a controlling interest in a company that is either young or heading into a growth spurt, as Pruchansky and other survey respondents do, you are both employer and employee. You have as much of a corporate interest in keeping your direct compensation low as you do a personal interest in setting it high. In many ways, you *are* the company—and what is good for the corporation is good for its ownership. That fact overshadows all other compensation questions.

Philip Nace, CEO of Nachem Inc., explains: "My major goal is to grow the company and increase its profits. My salary is secondary. I figure the more we build into the corporation, the more there'll be for me someday—whether we liquidate or sell, or whatever."

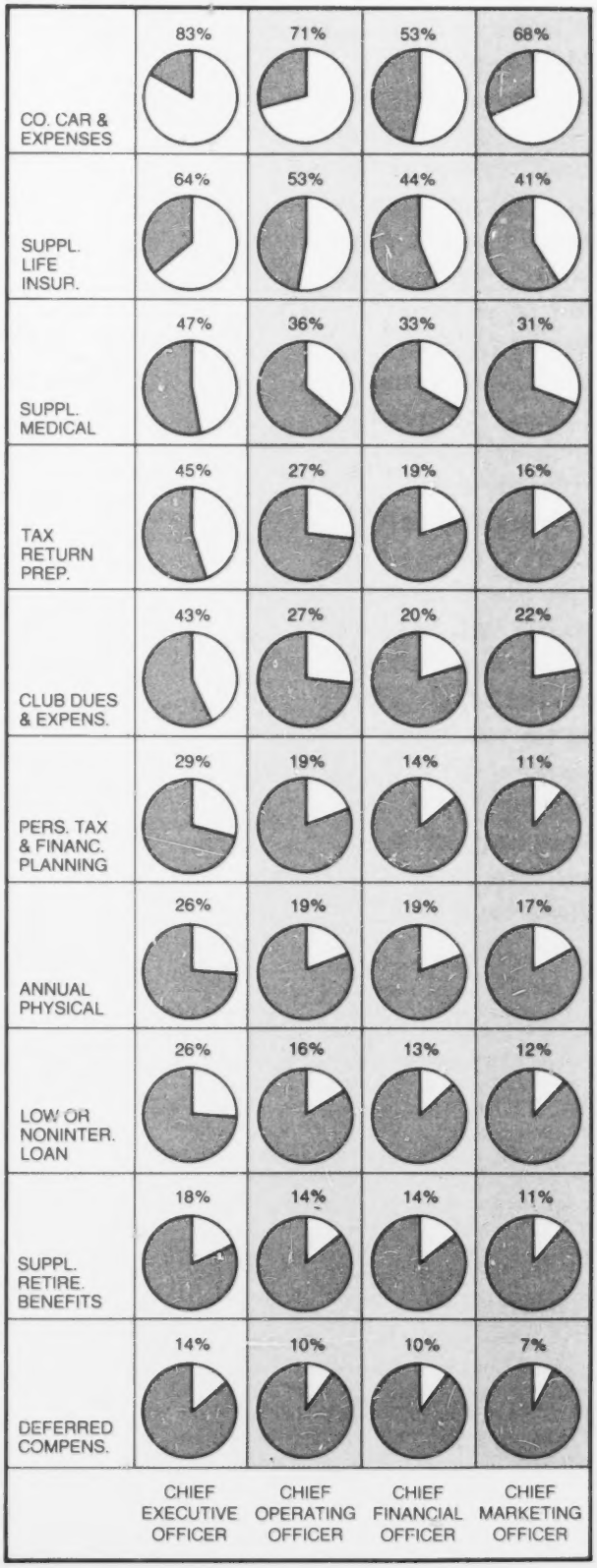
In such small, closely held companies, executive-compensation planning is a combination of business-strategy and personal-investment considerations. The decision of how much the CEO-owner should take out of the company—and, to a lesser extent, how much the rest of the top team should be compensated—has a lot to do with a company's cash-flow and reinvestment needs, as well as the owner's future plans for the corporation. Individual tax questions are also a very big part of the consideration.

"CEOs who own their own companies have to contend with questions that their counterparts in public companies never have to deal with," says Howard Miller, the national partner in charge of Peat Marwick's private-business advisory services practice. The decision-making process is fraught with tax dilemmas: "Do you take out salary and bonuses that will be taxed at, perhaps, 50%, or do you keep some or all of that money in the company, where it can't be taxed at more than 46%?" If the company's stock is sold, you will be taxed at capital-gains rates of not more than 20%, he points out. "So, if you're trying to send kids to college, maybe you take the salary. But if you don't have any heavy financial commitments, maybe you leave it in the company."

Keeping as much cash as possible in the company is the best choice for CEO-owners who have plans to sell out, liquidate, or bring the company public. Ask Pruchansky, who sold his company this past summer when Trend West Furniture Inc. made him an offer he couldn't refuse. If he had foreseen the sale, he would have held his salary down. "I would have wanted to build up my earnings," he explains. "Your selling price is always about 90% a function of that earnings figure. And, the less compensation you take out, the greater earnings you can show." Those same figures are used to determine the price-earnings ratio that convinces or dissuades would-be investors when a company makes an initial public offering, and they are the criteria for venture capitalists seeking out a deal.

There are plenty of owners, however, who aren't looking for that kind of payout. To them, "keeping it in the company" isn't so much a corporate-development strategy or a personal-investment decision as it is simply the way they prefer to do business. Some, like John Stearns, president and co-owner of Dixelle Co., a jewelry manufacturer in Pawtucket, R.I., see their mission as merely keeping costs down and the quality of their products up, partly to assure the day when they can pass the reins to one of their children—in Stearns's case, a son. To that end, the 63-year-old Stearns hasn't taken a salary increase in five years. Instead, he

Money isn't everything: the popular perks



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has plowed profits back into the company, to make sure his son starts off debt-free. "Anybody who starts a small business has got to put his money back into that business," says the elder Stearns, "because if the business doesn't grow, it will die."

"I don't need more salary," he continues. "My compensation comes in knowing I've built a strong, healthy business."

Billy McCalmon wholeheartedly agrees with that philosophy. As secretary-treasurer, general manager, and part-owner of a $1.1-million family-owned salvage business, he has only to look at his check stubs to know that "there is no such thing as executive compensation at Lynnwood Auto Wreckers Inc.," in Lynnwood, Wash. "The company couldn't afford it," he says, grinning. He, his father, and his uncle operate the five-employee company "pretty much out of our checkbook." Just having the property, he says, is "both our compensation and our retirement." They are all on straight salary—pretty minimal salary, at that—but the company is a living, and it will be so for generations to come.

This is not to say, however, that all CEO-owners of small, closely held corporations are selfless misers. One of the big perquisites of owning a company is the ability—entitlement, many say—to draw upon company cash and perks in ways that might catch flak from stockholders in a publicly traded company. Stearns, for example, may not be boosting his salary, but he considers his owner status as "money in the pocket." Whether he needs $1,000, or $45,000, to help pay for a new house, "I know I can always get it."

Even fairly obvious indulgence in the area of perks is often perfectly legal, says Hay Management's Jerrold Bratkovich. "I know the president of an $11-million electronics-assembly operation whose company owns a Learjet and a yacht. The assets are worth more than the company's sales. But it's impossible to separate that person's private life from his business life, because almost everything he does has some direct or indirect effect on the company."

Vernon Indermill, CEO of Summit Reprographics Inc., an $8-million supplier of engineering and drafting supplies based in Akron, believes that that aspect of the entrepreneurial life makes salary deprivation more than palatable. "I have everything I want. I'm having a great time. I'm combining business with pleasure, and building my equity with each passing day. Who could ask for more?"

Many CEO-owners could, according to the consultants. Compensation experts who have reviewed the INC. survey results have expressed surprise at the number of perks that respondents are *not* taking advantage of. Tax-return preparation, for example, is essentially a business-related expense for any stockholder, and, as such, is an obvious perk that would seem to be attractive to more than the 45% who listed it. Annual physicals (26%) and supplementary life insurance (64%) represent other underutilized opportunities to legitimately pass through an executive's personal expenses to the company.

What is the most popular perk? Cars and related expenses, which, at 83%, is a category that has almost lost its "perk" label. Many companies, in fact, now think of cars as just another piece of business equipment. The perk that seems to be losing favor the most rapidly is club dues and related expenses (43%). Some companies think such status perks attract the attention of the auditors, and others simply feel the day that companies had to entertain clients for business is gone.

There are other perks cropping up to fill the gap, however—home computers, burglar-alarm systems, and home WATS-line usage lead the list. And one of the most popular perks of all is one that nobody will own up to using: the highly illegal practice of allowing employees to make personal purchases on company accounts. As one CEO put it: "In a small, closely held company, we do some things that are marginal in terms of the tax code."

But the payoff for an entrepreneur is, in the final analysis, far more than the contents of any compensation package. When you come right down to it, says Miller, "saying that the average CEO makes $72,000 a year is grossly misleading. If that's all running a company was really worth, nobody would go into business," he says with a laugh. □

THE FACTS BEHIND THE FIGURES

This report is based, in part, on an executive-compensation survey conducted by INC. and the accounting and management consulting firm of Peat, Marwick, Mitchell & Co. The survey covered executive-pay levels and policies of a broad cross-section of smaller businesses, the research for which took place in March and April 1984. A four-page questionnaire was mailed to a random sampling of 20,000 INC. subscribers. The 1,016 returns were tabulated and cross-referenced by Peat Marwick.

The respondents represent small companies in all 50 states and the District of Columbia, with 22% headquartered in the Northeast, 18% in the Southeast, 28% in the Midwest, 11% in the Southwest, and 20% in the Far West.

By broad industry category, 26% of the respondents are in business services, 23% in wholesale/retail, and 16% in durable manufacturing. Other groups are professional services (14%), construction (9%), nondurable manufacturing (8%), and finance/insurance (5%). Classified by size, 89% of the respondents generate sales of less than $10 million. The largest number of respondents (23%) report revenues of $1 million to $2.49 million. Only 5% are publicly held.

Coordinating the project were INC. senior editors Bradford W. Ketchum Jr. and Mark K. Metzger. Peat Marwick's participation was provided through its Human Resources Consulting Group, with analysis by PM Pay, the firm's compensation survey group. Technical support was supplied by partner Peter T. Chingos (executive compensation) and national partner Howard N. Miller (private business advisory services).

Complete results of the INC. survey are available in a 230-page report compiled by INC. and Peat Marwick. Confidentiality of all responses is protected. To obtain a copy, send a written request and a check for $149.50 to: John Titus, INC. Executive Compensation Survey, 38 Commercial Wharf, Boston, MA 02110.

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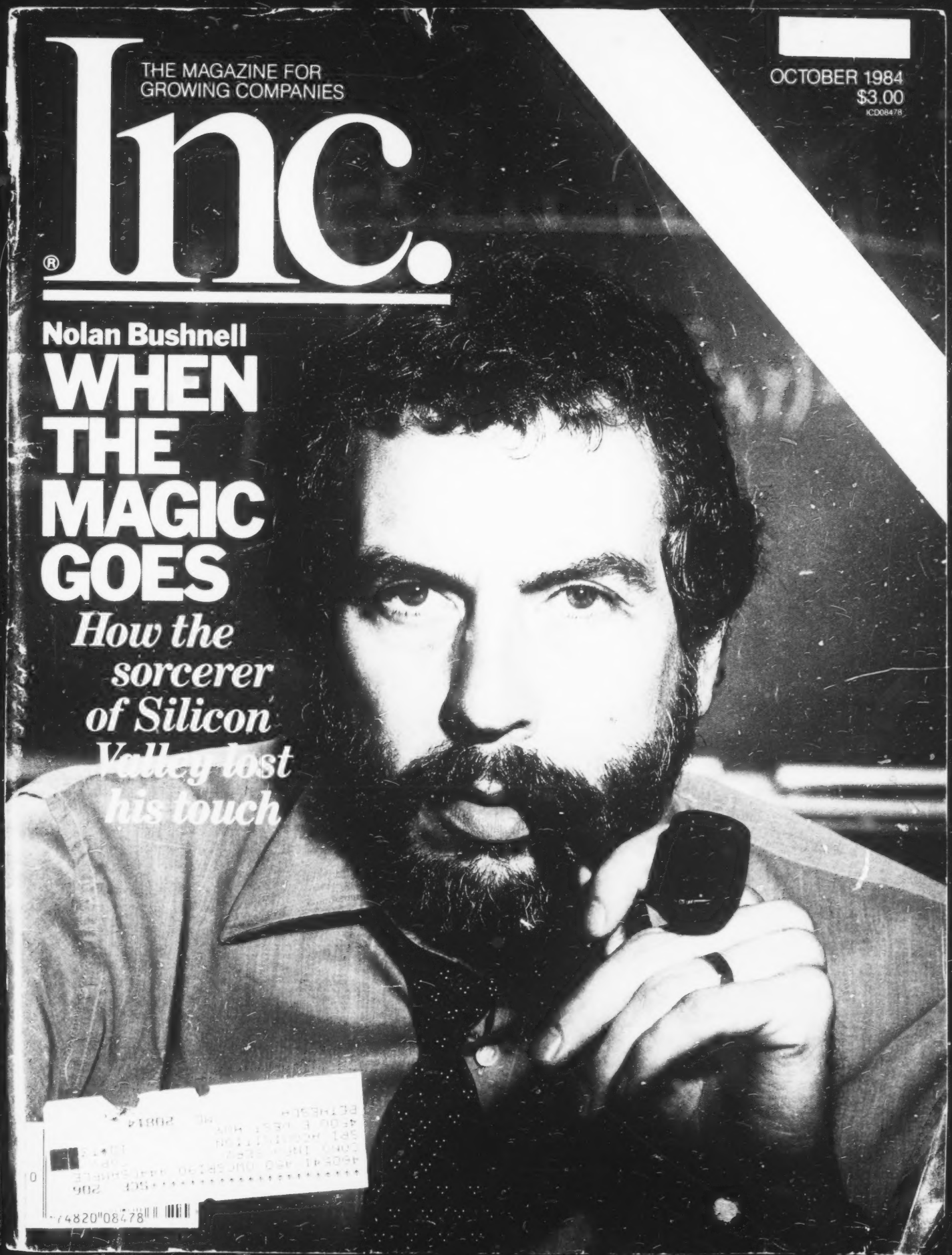

Nolan Bushnell
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